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SUBJECT: ECONOMIC REFORMS UNDER MEDVEDEV--ANALYSTS' VIEWS

REF: A. MOSCOW 558
¶B. MOSCOW 431

Classified By: Ambassador William J. Burns, Reasons 1.4 (b/d).

Summary

¶1. (C) The week following Medvedev's election we talked separately with four Moscow-based analysts about the prospects for market reforms under Medvedev: Renaissance Capital Managing Director Roland Nash; IMF Senior Resident Representative Neven Mates; consulting firm FBK's Director for Strategic Analysis Igor Nikolayev; and the Director of the Social Policy Institute in the Russian Academy of Sciences Yevgeniy Gontmakher. All four embraced Medvedev's goal of modernizing the economy. However, they also all agreed that rising inflation would limit Medvedev's policy choices and that the entrenched bureaucracy would resist reform. All agreed that Medvedev would have to generate early momentum to be successful. End Summary.

Plan Medvedev: All the Right Words

¶2. (SBU) Medvedev's pro-market rhetoric has generally been well-received by the business community, foreign and domestic, in Russia (Reftels A and B). In particular, they responded favorably to his February 15 speech in Krasnoyarsk, in which he called for Russia to develop a modern economy through four "I"s: innovation, investment, institutions, and infrastructure.

¶3. (C) The four analysts with whom we met in the week after the March 2 election agreed that Medvedev's proposals were a welcome sign that his presidency might put more stress on market reforms, which they argued were needed to sustain and accelerate Russia's economic growth. Nash noted that the conventional wisdom in Moscow was that nothing would change, given Putin's continued presence in the government. However he, like the other analysts, was cautiously optimistic that Medvedev would try to enact reforms but was concerned that the obstacles to successful implementation might be too great to overcome.

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Macroeconomic Environment Limits Policy Choices
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¶4. (C) Nikolayev said inflation was "problem number one" for the inbound president and said the issue should have been included among Medvedev's other "I"s in Krasnoyarsk. The country would not simply be able to grow its way out of the problem and the GOR would need to address the erosion that rising prices inflict on salary purchasing power. He stressed that inflation underscored the disparity between the policy environment facing Medvedev now and the one Putin encountered in 2000. Gontmakher said the same, noting that when Putin came to power "any reform was good reform" since the economy had only begun to recover from the 1998 financial crisis. However, in light of the economic gains and fiscal solvency Russia had achieved in the last eight years, Medvedev faced a less forgiving environment that would make his policy choices more complex.

¶5. (C) Nash suggested that one area to watch would be the GOR's emerging tendency away from a policy of budgetary austerity toward fiscal loosening, particularly in the direction of much-needed infrastructure improvements in transportation and communication. Tight monetary policy would, therefore, take on greater significance, according to Nash. However, he expressed uncertainty about monetary policy's efficacy in taming inflation, a view echoed by the IMF's Senior Resident Representative Neven Mates. Mates noted that Deputy Prime Minister Kudrin had made his reputation on tight fiscal policy and it was not yet clear whether he would agree to a looser policy, especially with inflation on the rise.

Entrenched Bureaucracy Will Resist Reform

¶6. (C) Nash said that administrative reform was the least defined of Medvedev's public pledges, and would not begin to take shape before Medvedev completed personnel changes among his advisors and, possibly, the Cabinet. Despite popular support, reducing bureaucratic corruption, particularly at the local level, would persist as a challenge since the GOR was obliged to use the bureaucracy to reform the bureaucracy. Nikolayev also agreed that lowering administrative barriers, from minimizing red tape to fighting bureaucratic corruption, could prove intractable. Those factors, nevertheless, bore much of the blame for the relative lack of competition in Russia, particularly for small business development.

¶7. (C) Regarding Medvedev's goal of precluding government officials from serving on the boards of state-owned enterprises (SOEs), Mates expressed doubt this was a serious pledge since Medvedev himself, as First Deputy Prime Minister and the Chairman of Gazprom, was "Exhibit A" for the need for SOE reform. Nikolayev speculated that this particular change would only come after the GOR clarified the status of SOEs, as a matter of law and practice. He noted that, by law, state corporations were to be established with an initial transfer of capital from the budget and, thereafter, were to operate as independent legal entities. However, the GOR's tradition of appointing the heads of SOEs and assigning officials to SOE boards had yielded a tendency to operate on the basis of political rather than market factors, according to Nikolayev.

Early Action Is Key

¶8. (C) Our contacts agreed that early action would be critical to Medvedev's success; Medvedev would need to demonstrate his sincerity and commitment to reform by taking action on one of his proposals by the end of the summer. Nikolaev thought personnel changes would be Medvedev's first step, speculating that the President-elect would appoint fellow law school classmate Anton Ivanov, currently the Chairman of the Supreme Arbitration Court, to lead his judicial and property rights reforms efforts. He also predicted that Medvedev would enact specific tax incentives in a first attempt at promoting greater innovation-oriented

industrial production, something that Nash and Mates felt was less likely.

¶9. (C) For his part, Nash thought Medvedev's early "low-hanging fruit" could be finalizing the land reform program that stalled under Putin as well as further changes to the tax regime for oil and gas companies to encourage upstream development. He also anticipated early personnel changes, such as replacing Central Bank Chairman Ignatiyev. Mates expressed a high degree of confidence that the fiscally conservative Deputy Prime Minister and Finance Minister Aleksey Kudrin would remain at the head of the GOR's economic policy team. Consequently, Mates forecast an uphill battle for a reduction in the value-added tax (VAT), which Putin and Medvedev had recently supported.

Medvedev's "Signals"

¶10. (C) Nash told us that Arkadiy Dvorkovich, the Head of the Experts Directorate in the Presidential Administration, had been the principal author of the Krasnoyarsk speech and had Medvedev's ear on economic policy. In that regard, Nash said a "Kremlin insider," presumably Dvorkovich, had told him that Medvedev was contemplating a public "signal" as to the direction his presidency would take. Nash said he had been told that the signals under consideration were: removing Igor Sechin from the Presidential Administration and from the board of Rosneft, and releasing Mikhail Khodorkovskiy from prison.

Comment

¶11. (C) The economy Medvedev inherits will limit his options, and the bureaucracy will be a formidable obstacle to overcome. The group of analysts with whom we spoke, in our view, missed one important "I": integration. Russia's WTO accession early in Medvedev's presidency would give powerful momentum to his reform agenda at home.
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